No. 12320

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

JAMES G. SMYTH, Collector of Internal Revenue, for the First District of California,

Appellant,

vs.

MURIEL E. BARNESON, also known as Muriel Elfrida Barneson, an Incompetent Person, by Lionel T. Barneson, Guardian,

Appellee.

On Appeal From the United States District Court for the Northern District of California.

BRIEF FOR APPELLEE.

FILED

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Opinion Below.

The District Court entered no opinion below. The findings of fact and conclusions of law [R. 74-78] are officially reported in 85 Fed. Supp. 657.

Jurisdiction.

This appeal involves federal income taxes and interest in the amount of $84,242.49 for the calendar year 1941. [R. 49.] These taxes and interest were paid June 28, 1945, and October 18. 1945. [R. 48, 75-76.] Within the time and in the manner provided by law a claim for refund was filed. [R. 48-49. 76.] More than six months after the filing of the claim and within the time provided by Section 3772 of the Internal Revenue Code or on

February 25, 1948, the taxpayer brought an action in the District Court for recovery of the taxes paid. [R. 22.] Jurisdiction was conferred on the District Court by 28 U. S. C., Section 1340. The judgment was entered on March 25, 1949. [R. 79-80.] Within sixty days and on May 19, 1949, a notice of appeal was filed [R. 88-89], pursuant to the provisions of 28 U. S. C., Section 1291.

Question Presented.

Whether the District Court correctly allowed taxpayer a deduction in the calendar year 1941 for a worthless debt under the provisions of Section 23(k)(1) of the Internal Revenue Code.[1]

Statute Involved.

Internal Revenue Code:

Section 23(k)(1), as amended by Section 124(a) of the Revenue Act of 1942 and by Section 113 of the Revenue Act of 1943, provides for the deduction of—

> "Debts which become worthless within the taxable year; * * *."[2] (26 U. S. C. 1946 Ed., Sec. 23.)

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[1]In the course of the opening statements [R. 104], the District Court stated "the real question" as: "Is a debt in existence in 1928-1929, becoming outlawed in 1933, the debtor dying in 1941, the claim being presented to his estate in 1941 and being disallowed, when if at all is it that the debt becomes worthless?"

[2]Section 124(d) of the Revenue Act of 1942, approved October 21, 1942, made the amendment contained in Section 124(a) applicable to taxable years beginning after December 31, 1938. The pertinent language of Section 23(k), *prior* to the retroactive amendment of 1942, provided for the deduction of "Debts ascertained to be worthless and charged off within the taxable * * *." In the case at bar the result would be the same under the old language as it is under the new, as 1941 was the year in which the debt both became worthless and was ascertained to be worthless.

Statement.

Appellant's statement of the case (Br. 3-8) fails to make reference to a number of undisputed facts which are consistent only with the ultimate fact found by the District Court, namely, that John Barneson was *indebted* to appellee in the amount of $150,000. [R. 75.]

The essential facts, showing the basis for the bad debt deduction of $150,000 from appellee's 1941 gross income allowed by the District Court, may be stated as follows:

The taxpayer, Muriel Barneson, in 1928 and 1929, transferred cash to her father, John Barneson, in an aggregate amount of $150,000. [R. 29.] John treated these transfers as loans; his double entry books of account contain an account payable entitled "Muriel E. Barneson Loan a/c" showing credits of $100,000 on May 8, 1928 and $50,000 on May 15, 1929. [R. 31; Ex. A. to Stip. of Facts.] No part of said $150,000 was ever repaid [R. 43; also Ex. A] but John Barneson at all times possessed the requisite financial ability to have paid $150,000 to taxpayer on demand. [R. 45.]

John Barneson died February 25, 1941, which was during the taxable year here involved, and his estate was probated in the Superior Court of the State of California in and for the County of San Mateo. On June 23, 1941, the taxpayer, acting through her guardian, filed in said court a creditor's claim for the $150,000 which she transferred to John in 1928 and 1929 and which John's books of account showed to be owing to her. On the same date this claim was rejected by the probate court on the ground that it was barred by the statute of limitations. Taxpayer did not bring suit on said claim within three months after June 23, 1941, or at any other time (*cf.* Sec. 714, Calif. Probate Code). [R. 44-45.]

In her 1941 federal income tax return the taxpayer took a bad debt deduction with respect to said $150,000. [R. 45-46.] This deduction was disallowed by the Commission and a deficiency of $70,369.97 was assessed. [R. 47.] This deficiency and interest of $13,872.52 assessed thereon were paid by taxpayer under written protest. [R. 48.]

The taxpayer duly filed a claim for refund. The Commissioner having failed to act on said claim within six months, this suit was brought. [R. 48-49.]

The case was defended in the trial court on a dual basis, in the alternative: (1) that John Barneson was never Muriel's debtor with respect to said $150,000; (2) that if he was her debtor, the debt became barred by the "California four-year statute of limitations * * * sometime in 1933 * * *"[3] and presumably became worthless in that year.

The taxpayer contended successfully that where, as here, the debtor is at all times abundantly solvent, the mere running of the statute of limitations does not render a debt worthless;[4] that John Barneson's debt retained some value, at least, at all times up to the date of his death in 1941; and that it became utterly worthless by reason of the event of death and the resulting operation of Section 708 of the California Probate Code, requiring disallowance by the probate court.

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[3]This quotation is from the defendant-appellant's brief in the District Court, p. 21, lines 30-31.

[4]This is a contention which the Government itself has successfully advanced in a number of cases, where the creditor sought a bad debt deduction solely because the debt became subject to the defense of the statute of limitations. See *W. C. Mitchell Co. v. Commissioner,* 27 B. T. A. 645, and cases cited therein at p. 648, particularly *Appeal of Leo Stein,* 4 B. T. A. 1016.

Summary of Argument.

I. The evidence that John Barneson was indebted to taxpayer in the amount of $150,000 is so convincing that a "finding" that he was not indebted would have been clearly erroneous. The finding of the District Court, based upon abundant and undisputed evidence which was consistent only with a debtor-creditor relationship, was clearly right.

II. Notwithstanding John Barneson could have invoked the statute of limitations at any time after 1933, his debt did not become worthless in 1940 or any prior year. It had some value, at least, up to the instant of his death on February 25, 1941—he might have paid it on, say, February 1, 1941—and became worthless on the date of death only because a California statute required the probate judge to disallow it. California Probate Code, Section 708. Both the debtor's death and the rejection of the creditor's claim having occurred in 1941, the debt clearly became "worthless within the taxable year" 1941.

III. Section 23(k)(1) requires *only* that a debt "become worthless within the taxable year" in order to be deductible. Where, as here, the taxpayer proves that a debt had value at the beginning of the taxable year and that it lost its value during the taxable year, the requirements of the statute have been completely satisfied.

In arguing, in Point II (Br. 17-20), that even though a taxpayer proves that a debt became worthless within the taxable year he is not entitled to a deduction unless he

also proves that he "had made a reasonable effort to collect the debt" (throughout, presumably, the *entire* period the debt existed), appellant asks this Court to add, by judicial legislation, to the only conditions prescribed by Congress a condition which would defeat the clear legislative intent. In order to prove, for example, that a debt became worthless in 1949, the taxpayer has to show that it had some value on January 1, 1949. If it had some value on that date, then according to appellant, it will be assumed that by diligence, some or all of it could have been collected in 1948. If appellant were right, by making the proof necessary to stay in court, the taxpayer would automatically prove himself out. He hasn't even the harsh choice between two horns of a dilemma. He can't win.

It is obvious, then, that carried to a logical, and not too extreme a conclusion, appellant's position reduces itself to absurdity. It is not surprising, therefore, that despite an experience with income tax laws of over 36 years, there is not a single reported decision which supports appellant's contention. The issue in *all* of the cases which appellant cites was whether the debt was *in fact* worthless. Worthlessness obviously cannot be proved without negativing the possibility that reasonable efforts to collect would be successful. The taxpayers in the cases cited by appellant lost because they failed to show that efforts to collect would be unsuccessful and hence failed to sustain their burden of proving that the debt was in fact worthless.

In the case at bar the evidence proved to the satisfaction of the trier of the fact that John Barneson's debt became worthless on February 25, 1941—"within the taxable year" —a finding which could not have been made unless the Court had been satisfied from the evidence that further collection efforts would have been futile.

Section 23(k)(1) calls only for determinations of *fact.* The facts as found show that the deduction was properly allowed.

IV. The decision of this Court in *Commissioner v. Burdette*, 69 F. 2d 410, shows that the District Court was right in giving judgment to appellee. That case supplies the answers to all of the contentions made in Point II of appellant's Argument.

ARGUMENT.

I.

The Trial Court Was Clearly Right in Finding That a Debt Existed.

The trial court, upon a lengthy, carefully prepared stipulation of facts [R. 26-50] and testimony that John Barneson had orally admitted in 1936 that he owed the taxpayer $150,000 [R. 119], found, as facts, that on January 1, 1941, the first day of the taxable year 1941, John Barneson was indebted in the amount of $150,000 to Muriel for cash loans made by her to him in 1928 and 1929 [R. 75]; that said debt did not become worthless at any time prior to February 25, 1941, the date of John Barneson's death [R. 76-77]; and that it became worthless within the taxable year 1941. [R. 77.]

The stipulation of facts consumes 25 pages of the printed record. [R. 26-50.] In addition, there were a number of exhibits which have not been printed. The stipulation naturally contains evidence which each side desired. All of this evidence was discussed in detail in the opening and reply briefs filed by appellee in the trial court. It would extend this brief to improper length to repeat that discussion in detail here, but it may be observed that while the record contains *no evidence whatever* which is necessarily inconsistent with the finding that John was Muriel's debtor, there is much undisputed evidence which is consistent *only* with a debtor-creditor relationship. The latter type of evidence includes the following:

1. Exhibit A to the Stipulation of Facts [R. 31], being the account payable to Muriel on John's books of account, showing a debt of $150,000.

2. Exhibit F to the Stipulation of Facts [R. 33], being a *similar* account payable to Harriet E. Barneson on John's books of account, showing a debt of $150,000. The Stipulation also shows that John got $150,000 from his wife, Harriet, in 1928 and 1929, at the same time and for the same purpose as he got $150,000 from Muriel. [R. 29.] (If John was the debtor of Harriet, presumably he was the debtor of Muriel.)

3. John turned over the $150,000 he got from Harriet and the $150,000 he got from Muriel, together with $125,000 from his own funds—a total of $425,000—to his son, Harold, for use in the stock brokerage business. [R. 28-29.] All of this $425,000 was lost when Walsh, O'Connor & Barneson failed in 1932. [R. 41-42.] John took a deduction for this *entire* $425,000 in his 1932 tax return even though his *other* losses were far in excess of his 1932 gross income and he would have had no tax liability even if he had claimed no part of this $425,000 as a loss. [R. 41-42; 108.] (If John were not the debtor of Harriet and Muriel, his 1932 loss would have been only $125,000.)

4. On the other hand, Muriel paid a 1932 income tax of $11,340.38, when she would have had no tax liability if she was a joint venturer or partner of John Barneson (as appellant urges) with respect to the $150,000. Muriel never claimed a deduction with respect to the $150,000 in any year except the taxable year 1941 involved in this case. And the Commissioner has never allowed any part of said $150,000 as a deduction in any

taxable year. [R. 42-43.] (If Muriel was a joint venturer or partner it follows that the Government is now unjustly enriched by $11,340.38, plus interest thereon since the 1932 tax was paid 16 years ago.)

5. Muriel received $400 from John Barneson in 1932 as compensation for the use of her $150,000. This was correctly reported as "interest" in her 1932 income tax return.

6. Following Harriet's death in 1936, John voluntarily informed his wife's executors that he owed her $150,000 and that he would have to pay her estate [R. 119-120], which he did in 1937 [R. 122; Ex. F.] At the same time he informed appellee's guardian that he owed her $150,000 and that he intended to pay her. [R. 119-120.]

7. Harriet's federal estate tax was $48,652.28 greater than it would have been had John not been Harriet's debtor with respect to the $150,000 which she transferred to him in 1928 and 1929. [R. 44.] (If John Barneson was not the debtor of Muriel, then for similar reasons he did not owe Harriet's estate $150,000, and the Government now stands unjustly enriched by $48,652.28, plus interest thereon since her estate tax was paid more than 12 years ago.)

The evidence which appellant claims points to a joint venture investment and not a loan is ambiguous or equivocal. This is true as to the notations on the check stubs and the erroneous labels on the income tax returns

for 1928, 1929 and 1931; as to label used in appellee's 1932 return, see 5 above.

The fact that John, in 1928, 1929, 1931 and 1932 paid Harriet and Muriel sums equal to a portion of amounts which he received from Harold as income on the $425,000, is entirely consistent with his being their debtor. *Astoria Marine Construction Co. v. Commissioner,* 1945 P-H T. C. Memorandum Decisions, par. 45,083; 1945 CCH T. C. Memorandum Decisions, par. 14,438 (M), in which the Tax Court *rejected* the contentions of the Commissioner. See also, 30 Am. Jur. 688.[5]

Considering all of the evidence, it is respectfully submitted that if the District Court had found that John was not indebted to Muriel, such a finding would have been clearly erroneous. *Cf.,* generally, *United States v. Lambeth,* 176 F. 2d 810 (C. A. 9th). It follows, of course, that the finding of the District Court is clearly correct.

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[5]The appellant's arguments with respect to the evidence to which he refers in his Point I were successfully answered in detail on pages 2 to 22 of Appellee's Reply Brief in the District Court.

II.

The Running of the Statute of Limitations in 1933 Did Not of Itself Render the Debt to Appellee Worthless. The Debt Only Became Worthless at the Instant of John Barneson's Death in 1941.

Appellee loaned John Barneson $100,000 in 1928 and $50,000 in 1929. This debt became barred by the California statute of limitations in 1933. (Sec. 337, Calif. Code of Civ. Proc.)

It has been invariably held in a number of cases that the mere running of the statute of limitations "does not extinguish a debt or render it worthless, but merely provides the debtor with an affirmative defense which may be pleaded against forcible collection." *W. S. Mitchell Co. v. Commissioner,* 27 B. T. A. 645, 648, and cases cited therein. And compare the decision of this Court in *Commissioner v. Burdette,* 69 F. 2d 410, where that rule was taken as settled by the Commissioner, the taxpayer and this Court.

In view of the stipulated fact that "At all times material hereto John Barneson possessed the requisite financial ability to have paid $150,000 to plaintiff [appellee] on demand" [R. 45], it is clear that John Barneson's debt did not "become worthless" at any time prior to the date of his death on February 25, 1941. And the District Court expressly so found. [R. 76-77, Finding X.] Since the probate court rejected appellee's creditor's claim on June 23, 1941 [R. 44-45], and suit thereon would have been futile (*cf.,* Secs. 708 and 714, California Probate Code), it is likewise clear that the debt did "become worthless within the taxable year" 1941. And the District Court expressly so found. [R. 77, Finding XI.]

III.

The District Court's Findings (1) That a Debt Existed and (2) That It Became Worthless Within the Taxable Year 1941 Meet the Only Tests of Deductibility Contained in the Applicable Statute.

Section 23(k) allows a deduction for "Debts which become worthless within the taxable year * * *."

The District Court's findings of fact [R. 75-77] bring the case squarely within the only tests of deductibility provided by the statute, which is clear and unambiguous.

Point II of appellant's argument (Br. 17-20) is, in substance and effect, a request that this Court hold, as a matter of law, that even though the evidence has proved the *existence* of a debt and that it *became worthless* within the taxable year—the only tests laid down in the statute—the creditor must *also* prove that throughout the entire existence of the debt he has made what appellant calls "a reasonable effort to collect the debt."

Appellant does not cite a single court decision which so holds. Nor can he—there is no such case. And the decision of this Court in *Commissioner v. Burdette,* 69 F. 2d 410, discussed more fully hereafter, clearly could not have gone in favor of Mrs. Burdette if that were the law, for she made no effort, "reasonable" or otherwise, to collect the debt from her abundantly solvent son.

Appellant no longer argues, as he did below, that, assuming a debt existed, it became worthless *prior* to the taxable year 1941. He seems to concede that it became worthless *within* the taxable year 1941 because John Barneson's death occurred on February 25, 1941, and

California law prevented his executor from paying it because it was barred by the statute of limitations.

Appellant suggests, however, that "The close relationship of the parties alone is sufficient to raise the question of whether or not the debt was forgiven." (Br. 18.) We have carefully examined the case which appellant cites —*Gallagher v. Commissioner*, 1939 P-H B. T. A. Memorandum Decisions, par. 39,010, 1939 CCH Board of Tax Appeals Service Decision No. 10,583-A. That case involved a loan by a father to his lawyer-son. The father lost his tax case *only because,* as the Board of Tax Appeals said, "* * * we can not find as a fact that the debt was actually worthless *at any time.* * * * it affirmatively appears that the debtor's situation was no different and no worse in the tax year than it had been for several prior years. * * *." (Italics supplied.) Contrary to the implication which appellant apparently desires this Court to draw (Br. 18), the Board, in the *Gallagher* case, made no finding of fact that the debt had been forgiven.

To be sure, one who *has been* a creditor is not entitled to a bad debt deduction if he forgave the debt *prior* to the time it might have become worthless if it had not been obliterated by forgiveness. But this is so because there is in such case *no debt* to which the statutory words "become worthless" can be applied.

But the appellee never forgave the debt of her father and the appellant did not even suggest that she did while

the case was before the trial court. The trial court's findings of fact, of course, necessarily exclude the idea that the debt was ever forgiven. [R. 74-77.] And the income tax laws do not contemplate anything like a twilight zone between a debt that has been forgiven and one that remains unforgiven.

Appellant asserts (Br. 18) that "had taxpayer chosen to ignore the family relationship, she could have collected the debt here sought to be deducted." This is a paraphrase of language which appears near the bottom of page 583 of the opinion in *Nathan H. Gordon Corp. v. Commissioner*, 2 T. C. 571, cited by appellant, relating to the *Wallenstein* loan. Deduction of *that* loan was disallowed not because of the family relationship (the debtor was married to Nathan H. Gordon's niece) but because "The petitioner was not justified in considering the debt worthless." (1st sentence of last par. on p. 583.)

But compare, on the very next page of the same opinion, the Tax Court's allowance of a deduction of the Gordon Corporation's loan to *Nick Gordon*, nephew of Nathan Gordon. The court said (p. 584 of 2 T. C.):

> "We have no doubt that the record spells out the basis for the allowance of the deduction. It is possible that the petitioner was *too indulgent* to Nathan H. Gordon's nephew, but before 1936 it had no reason to doubt the collectibility of the note. It then proceeded to ascertain the true condition of the debtor's affairs and justifiably came to the conclusion that the debt was worthless." (Italics supplied.)

Perhaps the appellee may have been "too indulgent" with respect to her father's debt.[6] But as the *Gordon Corp.* case, *supra,* shows, this is irrelevant where there is in fact a debt and it becomes worthless within the taxable year. *Block v. Commissioner* and *Thom v. Burnet,* cited by appellant (Br. 18-19), are cases where the debts involved had not in fact "become worthless"—in the taxable year for which deduction was sought *or at all*—and the deduction was disallowed for *that* reason, not because of a family relationship or "too indulgent" treatment of the debtor. Hence the *Block* and *Thom* cases are not applicable where, as here, the debt concededly became "worthless within the taxable year."

Appellant asserts (Br. 19) that "It is evident that in order to entitle himself to a deduction of a worthless debt, a taxpayer must not only prove that a debt in fact exists but that he has taken all reasonable steps to collect the debt and exhausted all possibility of obtaining reimbursement." He cites *Allen-Bradley Co. v. Commissioner,* 112 F. 2d 333, 335 (C. A. 7th), a case which was rightly decided but which examination discloses to be clearly distinguishable on the ground, among others, that the Board of Tax Appeals refused to find that the particu-

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[6]While appellee was not adjudicated to be incompetent until April 3, 1936, it is not disputed that she has been unable to carry on her own personal business affairs since March, 1931. [R. 114; Defendant's Proposed Finding II, R. 55.] By the time appellee's guardian was appointed, the California statute of limitations had long since run. The guardian learned of the debt to appellee at the same time that he learned of John Barneson's similar debt to Harriet Barneson. [R. 119.] And the guardian, as executor of Harriet's will, received payment in full of John's $150,000 debt to Harriet in 1937, four years after that debt became barred. He thus had every reason to believe that John would eventually pay his debt to appellee.

lar "debt" which the taxpayer was seeking to deduct *ever* existed.

The Memorandum Findings of Fact and Opinion in the *Allen-Bradley Co.* case are reported in the CCH Board of Tax Appeals Service as Decision 10,688-B, May 8, 1939. Allen-Bradley Co. was a Wisconsin manufacturing corporation. All of its stock was owned by Lynde and Harry Bradley, brothers, president and treasurer, respectively. Their mother, Clara L. Bradley, died February 13, 1933, leaving a net estate of over $15,000, all of which (except for a wrist watch and $100) went to Lynde and Harry under a will executed in 1924 and of which they were executors.

Allen-Bradley Co. took a bad debt deduction for 1934 in the amount of $8,351.45 with respect to an account receivable opened on its books in the name of Clara Bradley in January, 1931, at the direction of her sons. Between January, 1931, and the date of Mrs. Bradley's death in February, 1933, the corporation had expended its own funds for expenses of Mrs. Bradley's medical care, charging them to this account. Before any item was paid, it was first approved by Lynde.

The Board made findings of fact that no note or other evidence of indebtedness was ever given to the corporation by Lynde or Harry for the amounts advanced *at their request* to pay the expenses of their mother. It also made the significant finding that Mrs. Bradley had no knowledge that such advances were being made by the taxpayer corporation.

Ten days after the death of his mother, Lynde, acting as an officer of the taxpayer corporation, filed a claim against Clara's estate for the full amount of $8,351.45.

Lynde and Harry, *as executors,* paid the claim on the advice of their attorney, Leo Mann, who was also attorney for the estate.

After such payment but prior to hearing before the Milwaukee County Probate Court, Mann went over the various claims with the Public Administrator, who is an officer of the State whose duty it is to safeguard the interests of the State. That official pointed out to Mann that under Wisconsin statutes the claim could not be proved by the testimony of Lynde or Harry. At the hearing before the Probate Court no evidence was offered by the Allen-Bradley Co. to establish the validity of its claim against Clara's estate. Therefore the claim was formally disallowed by the Court on June 26, 1934, following which the taxpayer corporation repaid Clara's estate, charged the amount off as worthless and uncollectible as of December 31, 1934, and claimed a bad debt deduction in its 1934 return, which the Commissioner disallowed.

The concluding paragraph of the Board's findings of fact reads as follows:

> "Lynde and Harry Bradley expected that the sums advanced by petitioner for Mrs. Bradley would be repaid either by her or from the estate. They were not, but the Bradleys were the sole beneficiaries of the estate. In 1934, Lynde and Harry Bradley were solvent. Petitioner did not exhaust all reasonable means to make collection *from Lynde and Harry Bradley.* The sums advanced by petitioner were *not* uncollectible in 1934." (Italics supplied.)

The Board expressly stated in its Opinion that it made no finding that there was a debt of Clara to the taxpayer corporation. Without such a finding there could, of course, be no finding that any debt became worthless, and that could well have been the sole basis of the Board's decision against the taxpayer corporation.

However, it is also clear that the Board considered that the evidence showed that Lynde and Harry had agreed with their corporation that its advances would be repaid either by Clara or *from* her estate, and that Clara's sons should have repaid the Allen-Bradley Co. out of their $15,000 inheritance or otherwise. The Board in the last two paragraphs of its opinion, said:

> "* * * there could be *no reason* why Lynde and Harry Bradley *could not recognize their agreement with petitioner* to reimburse it for the sums advanced out of the net estate of Mrs. Bradley, in their individual capacity as sole beneficiaries of her estate. The *sole* ground for petitioner's claim that it ascertained the account receivable to be worthless in 1934 is founded upon the disallowance of the claim by the Probate Court of Milwaukee County in the State inheritance tax proceeding. This is a technical ground and is *not sufficient in this proceeding to prove that the account receivable was not collectible either in 1934 or thereafter.* Depending upon when the estate became distributable free and clear to Lynde and Harry Bradley, petitioner could make a claim *against the Bradleys* for repayment in some manner, according to the original understanding that petitioner would be reimbursed this [*sic*] defeats petitioner's claim that it ascertained to be worthless an alleged debt in 1934.

> "We make *no finding* that there was a debt of Clara L. Bradley, deceased, to the petitioner. It is another question whether the agreement between petitioner and Lynde and Harry Bradley was such as to amount to an obligation of them individually to reimburse petitioner. *We think* that there was such an obligation in Lynde and Harry Bradley, but the proceeding has not been tried upon that theory and we make no holding with respect to any possible debt from the Bradleys to the petitioner. However, upon the record, which shows that *all possibility of obtaining reimbursement had not been exhausted in the taxable year,* it is held that petitioner did not ascertain any debt to be worthless in 1934 and respondent is sustained in the disallowance of the deduction claimed." (Italics supplied.)

For the Allen-Bradley Co. to have succeeded in reducing its 1934 income tax liability by getting the benefit of a bad debt deduction in the circumstances outlined above would have amounted to a monstrous fraud on the revenue. Clara Bradley was financially able to pay her own medical expenses. If for convenience, or for any reason, Clara's sons did not see fit to spend their mother's funds during her lifetime for her medical expenses—Lynde had her power of attorney—but chose to use other funds, that was their privilege. But it was not the business of Allen-Bradley Co., the corporation, to make a loan to Clara Bradley—the Board's findings show that she was never an employee of that corporation.

The Allen-Bradley Co. clearly could not have taken a deduction, as a business expense, of the amounts it paid out for Clara Bradley's medical expense. Neither could Clara's sons have taken a deduction if they had used

their own funds to pay their mother's medical expenses. To have permitted the corporation to obtain a bad debt deduction for the same items would have been to permit a tax benefit to be obtained *by Lynde and Harry* indirectly that could not be obtained by direct means.

Lynde and Harry "inherited" $15,000 from their mother and this was free from income tax—Section 22(b)(3) of the Revenue Acts and I. R. C. Actually, their true inheritance was only $7,000 ($15,000 less the $8,000 spent by their wholly-owned corporation). Elementary principles dictate that the corporation should not get a deduction—as a bad debt or otherwise—for the $8,351.45 spent by it at the request of the owners of all of its stock for the benefit of their mother. Indeed, a reasonably astute revenue agent would have gone further and would have suggested to Lynde and Harry Bradley that unless they repaid the $8,351.45 to the corporation they would individually be taxed with respect thereto as for constructive receipt of a dividend, for, in the absence of an intent to repay, that was what the disbursements of the corporation really were—dividends to Lynde and Harry.

It is submitted that a careful analysis of the *Allen-Bradley* case will show: (1) that it was correctly decided; (2) that Clara Bradley was never the debtor of that corporation (whatever her status as to her sons) and that, therefore, the *particular* "debt" for which deduction was claimed *never* existed; (3) that either (a) Lynde and Harry were indebted to the corporation, in which event there was no *worthless* debt, or (b) the disbursements were dividends *constructively* paid to Lynde and Harry and the corporation was *never* the creditor of anyone.

The opinion of the Court of Appeals in the *Allen-Bradley Co.* case goes no further than to say that if a taxpayer proves the existence of a debt owing to him, he cannot sustain his additional burden of proving that the debt has become worthless where the evidence fails affirmatively to show that reimbursement is no longer possible *"in the taxable year."*[7] This is good law and many decisions in bad debt cases have so held.

Where the debtor is *alive,* the creditor must necessarily prove, if he is to get a deduction, that the debtor, at the end of the taxable year in which the deduction is claimed, has no assets out of which the debt might be satisfied even in part. Otherwise, the creditor cannot possibly show that the debt has "become worthless" and cannot meet *that* statutory test. In addition, the creditor must also show that the debtor had some assets in *prior* years out of which the debt could have been satisfied, at least in part. Otherwise, the creditor cannot possibly show that the debt became worthless "within the taxable year," the *other* statutory test. Evidence offered for these purposes will necessarily disclose what efforts the creditor made to collect, but it is not the making of efforts to collect that the statute requires; what is required is proof that (a) the debt *is* worthless, and (b) that it *became* "worthless within the taxable year."

In the case at bar the debtor died within the taxable year 1941. As the District Court found, the debt "did not become worthless at any time prior to February 25, 1941, the date of John Barneson's death." [R. 76-77.]

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[7]The italicized words are those of the Board in the *Allen-Bradley* case; for the full context see quotation *supra,* p. 20.

It is not now disputed by the appellant that, assuming John Barneson was appellee's debtor, the debt became worthless within the taxable year 1941, as the trial court found. [R. 77.] Obviously it can not be said that reimbursement was possible *after* the instant of John's death on February 25, 1941.

There is nothing in the *Allen-Bradley Co.* case that says that where a debt exists and the evidence shows that it has "become worthless within the taxable year" the taxpayer cannot have a bad debt deduction if it appears that by the exercise of different or better judgment in the past the creditor might have collected the debt *prior* to its becoming worthless. Nor does the statute say so.

Income tax statutes have never insisted on infallibility of judgment. The very existence of the bad debt provision itself shows that. "To be sure, it may not have been a wise loan, but the law does not say nor does it contemplate that only debts wisely contracted are deductible." *Redfield v. Eaton*, 53 F. 2d 693 at 694.

Examples of poor judgment not affecting deductibility are to be found in the following cases under the bad debt section: *Nixon v. Commissioner,* 2 B. T. A. 524; *Cruger Co. v. Commissioner,* 11 B. T. A. 306; *Robert S. Dennison v. Commissioner,* 4 T. C. 806. A recent decision of the Tax Court in *Gorman Lumber Sales Co. v. Commissioner,* 12 T. C. 1184, June 30, 1949, involved the deductibility of a debt of a sole stockholder to his wholly-owned corporation. The findings of fact are such that it might well be said that the taxpayer was "too indulgent" with its stockholder in respect of the debt which he owed it. But the Tax Court nevertheless rejected the contentions of the Commissioner, found that the debt became worth-

less in 1942 and constituted an allowable deduction for that year under section 23(k).

Appellant's position amounts to saying that although the creditor's human fallibility does not prejudice him so far as the *creation* of the debt is concerned, he must from that moment on become not only infallible in *enforcing* collection, but without leniency or mercy, even against a parent. The law does not prescribe a standard of conduct so impossible or undesirable. (*Cf., Sooy v. Commissioner,* 10 B. T. A. 493.) It grants that some of the mistaken judgment which induced the making of the loan may result in measures short of the extreme in its enforcement, being satisfied if the debt actually becomes worthless within the taxable year, even though a creditor possessed of greater toughness or wisdom would not have sustained the loss.

If a loan is made in 1947 to a solvent debtor, repayable on demand, and becomes worthless in September, 1949—by reason of a sudden and complete deterioration in the debtor's financial condition—deduction therefor in the taxable year 1949 is not defeated by a showing that the creditor could have collected in, say, December, 1948, if he had demanded payment *at that time.* Indeed, there is an affirmative burden on the creditor to show that he could have collected in December, 1948; otherwise the evidence will not negative the possibility that the debt became worthless *prior* to the taxable year 1949.

It is clear, then, that the appellant is inviting this Court to read into the plain language of Section 23(k)(1) something that Congress not only did not put there but which would render the deduction provision meaningless. A taxpayer cannot get a deduction in the taxable year

1949 without showing not only that the debt *is* worthless but also that it did not *become* worthless in 1948 or some prior year—in short, that the debt had some value, at least, on January 1, 1949. If the debt did have some value on January 1, 1949, that was because at least a part could have been collected on December 31, 1948, if demand had been made at that time. If failure to make a demand for payment while the debt has value is to be allowed to thwart a deduction in the taxable year in which the debt becomes worthless, in what taxable year can a taxpayer get the deduction for which Congress provided?

Let us examine the remaining cases cited in appellant's brief.

Appellant quotes (Br. 19) from *H. D. Lee Mercantile Co. v. Commissioner,* 79 F. 2d 391, 393 (C. A. 10th), and asserts that the Court was "commenting upon the failure of a taxpayer to take reasonable steps to collect a *debt.*" (Italics supplied.) The appellant's use of the word "debt" (p. 19) is incorrect and very misleading—as appellee pointed out in distinguishing this case at page 23 of her reply brief in the trial court.

A reading of the entire opinion in the *Lee Mercantile Co.* case shows that it lends no support to appellant. The Lee Mercantile Co. was a *purchaser* of goods, *not* a lender of money. It kept, used, and paid for the purchased goods, notwithstanding its claim that they were not up to standard. The Court said that "an unadjudicated claim for breach of contract" cannot "be considered a debt * * *." (Citing cases.) Hence, the *bad debt* provision of the income tax statute, though invoked by the taxpayer, was not really involved, and some of the language of the Court, dealing with losses in mercantile or other *busi-*

ness transactions, *not involving loans,* must be read with realization of that fact. As the Court in the *Lee Mercantile* case said, the Supreme Court has held that the "loss" provision and the "bad debt" provision are "mutually exclusive." *Spring City Foundry Co. v. Commissioner,* 292 U. S. 182, 189.

Appellant cites and discusses (Br. 19-20) *Grover Bowser v. Commissioner,* decided July 29, 1948 (1948 P-H T. C. Memorandum Decisions, par. 48,137; 1948 CCH T. C. Memorandum Decisions, par. 16,528 (M)). Appellant's brief in the trial court (pp. 16-19) relied on the *Bowser* case, but appellee's reply brief was apparently successful in distinguishing that case to the satisfaction of the trial court.

Grover Bowser's father-debtor died in 1941. The son-creditor did not claim a bad debt deduction until 1943—*two years later* and, therefore, two years, at least, too late. The findings of fact do not show the year in which Bowser asked for payment or when the administrator orally refused payment. It is reasonable to assume, however, that Bowser made his request sometime in 1941, the year of death, or at the latest in 1942.[8] Hence the debt became worthless *prior* to Bowser's taxable year 1943 because at *no* instant of time during that year was there any possibility that it would be paid.

[8]The Kansas Statutes require an executor or administrator, within thirty days after his qualification, to publish notice of his appointment to creditors, heirs, etc. Creditors have nine months from the date of first publication to exhibit their demands against the estate. Claims not so exhibited are forever barred unless otherwise provided in the will. *Kan. Gen. Stat. 1947 Supp.,* Secs. 59-709, 59-2239; 2 *Bartlett, Kansas Probate Law and Practice* (1939), Ch. 50, Secs. 1111-1130.

In the case at bar, however, the taxable year is 1941. John Barneson died February 25, 1941. If Muriel's guardian, on, say, January 2, 1941, had asked John to pay, there can hardly be any doubt on this record that he would have paid it immediately. Certainly it can not be assumed, in determining whether the debt had value on January 2, 1941, that John would have invoked the statute of limitations as a defense. And without such an assumption the debt was not "destitute of worth, of no value or use"[9]—at any time prior to the instant of death.

Another basis for distinguishing the *Bowser* case is that there was no showing *of fact* therein that the debtor at *all* material times had the requisite financial ability to have paid the note on demand after maturity in 1924. Thus the debt might well have "become worthless" in 1928—prior to the running of the Kansas statute of limitations in 1929—or in, say, 1932. If the proof in the *Bowser* case —which involved only $386.66 and apparently was not too thoroughly prepared—had shown that the debtor had possessed the requisite financial ability to have paid the note *at all times* between 1924 and the date of his death in 1941, *and* if Grover Bowser had taken his deduction *in the year of death,* rather than two years later, it would seem that he would have been entitled to the deduction. Judge Johnson of the Tax Court said that Bowser "has not addressed his evidence to the establishment of *any* necessary conditions precedent for deduction of the debt due him." (Italics supplied.)

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[9]This definition of "worthless"—as used in the bad debt section—is the Government's, and it was approved by Chief Justice Hughes in *Spring City Foundry Co. v. Commissioner,* 282 U. S. 182.

In the case at bar appellee *negatived* the idea that John Barneson's debt to her might have become worthless in 1940 or some prior year by seeing to it that the record showed [R. 45, Stip. par. 25] the fact that "At all times material hereto John Barneson possessed the requisite financial ability to have paid $150,000 to plaintiff on demand."

The result in the *Bowser* case is unquestionably correct. There was a failure of essential proof that the debtor could have paid *at all times* prior to the taxable year in which the deduction was sought. But if the opinion in the *Bowser* case is to be read as indicating that Judge Johnson believed, as a matter of law, that the mere running of the statute of limitations automatically renders a debt worthless, then, with deference, we respectfully urge that he is in error both as a matter of common experience and as a matter of law.[10] The true rule of law—implicit in the decision of this Court in *Commission v. Burdette, supra*—was aptly stated in *W. C. Mitchell Co. v. Commissioner,* 27 B. T. A. 645, 648, *supra,* p. 12. The *Mitchell Co.* case, it will be observed, was *reviewed* by the *full* Board of Tax Appeals, whereas *Bowser* is the opinion of a single judge.

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[10]That Judge Johnson, who decided the *Bowser* case, did not intend it to be so read is indicated by his later, and recent, opinion (July 7, 1949), in *Thorman v. Commissioner,* CCH T. C. Memorandum Decision No. 17,107 (M). The loan in the *Thorman* case was made in 1929. It became barred by the applicable Texas statute of limitations in 1933; Thorman conceded this and Judge Johnson, a former Texas lawyer himself, decided the case on that hypothesis. Judge Johnson nevertheless rejected the argument of the Commissioner that "no debt existed in 1943," which was the "taxable year," and held, on the facts, that "McDermott's debt [to Thorman] did not become worthless prior to 1943" although it had become subject to the Texas statute of limitations ten years earlier.

Appellant's statement (Br. 20) that the Tax Court, in the *Bowser* case, "denied the deduction of the note as a worthless debt" is true. But the inference which appellant seeks to have this Court draw—that the Tax Court thought the note was collectible and that the deduction should be disallowed because of Bowser's "failure to enforce payment" (Br. 20)—is very misleading. There is nothing in its findings or opinion that indicates that the Court thought that the Bowser note was collectible at any time during the "taxable year" 1943; quite the contrary. A reading of the last two paragraphs of the opinion shows that the court was merely answering a contention of Grover Bowser—that if he had presented his claim to the Kansas probate court the debtor's administrator would have been required to pay—when it said, in effect, that even if this were so, "it does not advance petitioner's [Bowser's] position, for failure to enforce payment of a collectible note does not support a deduction." (Citing *Griffiths v. Commissioner,* 70 F. 2d 946 and *Thom v. Burnet,* 55 F. 2d 1039.)

The correct rule of law is that where the debtor is alive and solvent, the creditor cannot successfully claim a deduction. That was the factual situation in the *Griffiths* and *Thom* cases, *supra*. The reason is obvious: in such cases there is no proof that the debt is worthless; quite the contrary. But this is not to say that where the death of a solvent debtor occurs and state law prevents payment by the executor, the debt does not "become worthless" *in the year of death* if the creditor allowed the statute to run in a prior year. *Cf. Commissioner v. Burdette,* 69 F. 2d 410 (C. A. 9th), discussed at length under Point IV, *infra.*

IV.

The Judgment Below is Completely Supported by the Reasoning and Decision of This Court in Commissioner v. Burdette, Supra.

The decision of this Court in the *Burdette* case, *supra,* contains within it the answer to every contention which the appellant has made or can make.

Mrs. Burdette loaned her son $27,500 in 1915, evidenced by two interest-bearing notes payable "Thirty days after demand." 400 shares of stock in the Torrance-Marshall & Co. were deposited as collateral security. In 1922, while the son and debtor was ill, he sold the collateral and requested his mother to release it, which she did, and no other security was substituted instead. *No demand for payment was made* and no part of the indebtedness was ever paid, nor did the debtor repudiate the notes, but collection by suit had become subject to the defense of the California statute of limitations *many years* before the taxable year 1924—probably in 1919.

The debtor died in 1923, leaving an estate valued in excess of $200,000. Early in 1924, a creditor's claim was presented to the executor, and allowance and payment were refused on the ground that the debt was barred by the statute of limitations. Mrs. Burdette then, in 1924, considering the notes to be worthless, charged them off and took deduction therefor in her income tax return for the year 1924.

The Commissioner, as the opinion of this Court shows (69 F. 2d at 411, 1st col.), disallowed the deduction on the ground that since "the debt actually became worthless *upon the death* of the debtor in 1923, the respondent [Mrs. Burdette] will be *conclusively presumed* to have as-

certained that fact when it occurred, and that therefore the debt was deductible in 1923 only." (Italics supplied.)

The question involved in the *Burdette* case was stated as follows (69 F. 2d at 411, 1st col.):

> "The sole question involved is whether the indebtedness represented by these notes should have been written off in 1923, the year in which the maker died, or in 1924 when claim for payment was rejected by the executor; the collection of the notes concededly being barred by the California statute of limitations."

The Commissioner lost the *Burdette* case, but only because the "old" bad debt deduction provision (in effect in 1923 and 1924, but radically changed in 1942, retroactively as to taxable years beginning after December 31, 1938—(see footnote 2, *supra,* p. 2), permitted a deduction in the year the creditor *"ascertained"* it to be worthless and charged it off. Under *that statute,* as was said in *Jones v. Commissioner,* 38 F. 2d 550 at 553 (C. A. 7th):

> "* * * the real question * * * is, not when did the debt become worthless, but when did decedent ascertain it to be worthless."

This construction was followed in the *Burdette* case. This Court held that Mrs. Burdette was entitled to take the deduction in 1924—the year following the year in which her solvent debtor died, but the year in which her creditor's claim was rejected—because she had believed in good faith "until the payment was refused by the executor in 1924" (69 F. 2d at 411, 1st col.) that a memorandum which the debtor had given her on April 20, 1923, was "a valid and binding extension of the statute of limita-

tions." (69 F. 2d at 411, 2d col.) As it was not until 1924 that Mrs. Burdette first learned that the memorandum was not effective, it was not until 1924 that she "ascertained" the debt to be worthless.

Under the "new" bad debt provision, which is applicable in the case at bar, the question is, however, not when did the taxpayer *ascertain* the debt to be worthless, but "when did the debt become worthless" in fact. As has been said by the Tax Court in a memorandum opinion in *Ewing Hymers v. Commissioner,* 1944 P-H T. C. Memorandum Decisions, par. 44,407, 1944 CCH T. C. Memorandum Decision 14,300 (M), allowing a deduction for a bad debt in the taxable year 1941:

> "The effect of this amendment [Sec. 124(a), 1942 Act] is to allow a deduction for a debt which has become worthless in the taxable year when it actually became worthless, without reference to the year in which the charge-off was made or worthlessness ascertained."[11]

It is clear, we submit, that the Commissioner was right in one of the two contentions which he made in the *Burdette* case, namely, that "the debt actually became worthless *upon the death* of the debtor in 1923, * * *." It follows that the debt of $150,000 which John Barneson owed the appellee "actually became worthless upon the death of the debtor" on February 25, 1941, although the fact of worthlessness was not realized or "ascertained" by appellee's guardian until the probate judge rejected

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[11]In March, 1942, when appellee's 1941 return was filed, the "old" provision had not been superseded as to 1941; and the statutory words "charged off" account for the notation made by appellee's guardian on the check stubs, photostats of which are parts of Exhibits C, D and E to the Stipulation of Facts, R. 31-33.

appellee's creditor's claim on June 23, 1941. The deduction was claimed in appellee's return for the taxable year in which her debtor died, and it is submitted that the facts and the law sustain the deduction as claimed.

Conclusion.

The judgment of the District Court should be affirmed.

Respectfully submitted,

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